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BUSINESS AND THE LAW

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Introduction

It is a fact of life that as we grow older our lives grow increasingly more complex. This is partly due to the expansion of our individual interests as we enter the mainstream of American society. The greater factor complicating our lives, however, is the accelerating complexity of the society in which we live. Technical innovations have propelled us into a world different from the one in which we were born, or matured, or raised a family.

The state of the law is but one example of the increasingly dynamic state of our society We devote this issue of the *Indiana Business Review* to topics in law affecting business. Some of you readers may have taken a business law course several years ago that concentrated on teaching you what the current law is. As you have no doubt discovered this approach has its limitations, for the law is not static, but instead is constantly changing. Some areas of the law have changed dramatically in the last twenty years. Other areas did not even exist twenty years ago.

The dynamism of the law is the major theme of the articles in this issue. Our authors' goal is to show you that law evolves not in some helter-skelter fashion but, as Professor Metzger writes, reflects contemporary social and economic needs and values. By explaining the connection between these needs and values and the past and present state of law, our authors hope to enable you to anticipate changes in law by observing the social and economic setting in which you live. And by equipping you with the tools to anticipate legal changes, we hope that you may more easily succeed in the business world.

L. Thomas Bowers
Consulting Editor

Job Security in the 1980s

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One prominent legal historian has observed that "the strongest ingredient in American law, at any given time, is the present: current emotions, real economic interests, concrete political groups."[1] An examination of the development of virtually any major area of our law provides ample evidence of the powerful influence contemporary social needs and values have on the evolution of legal rules. A look at the growth of our law in the area of job security from this sociohistorical perspective not only confirms the validity of this method of legal analysis, but, more importantly, explains contemporary developments in this area and enables us to predict the likely course of future legal rules governing the employment relationship.

In the eighteenth and the early nineteenth century in America eighty percent of the work force was self-employed and such employment relationships as existed were personal and highly paternalistic. Apprenticeships were common, with the employer being seen as standing *in loco parentis* to his employees, with a duty to train them and to see to their secular and religious education. Courts protected such workers from unfair discharge. Employment conditions were relatively nonhazardous, and a scarcity of labor and the ability to live off the land in an agrarian society meant unemployment was not a significant problem. All large organizations were objects of distrust: corporations were few in number and small in size and labor unions were viewed as criminal conspiracies.

The Industrial Revolution changed all this, however, as the emerging factory system produced impersonal employment relationships, dangerous working conditions, and a large pool of landless, wage-dependent workers. The emerging business cycle also began to produce periodic unemployment. The courts, perceiving the promotion of industrialization as the paramount social goal of the era, responded to these changing conditions largely by evolving a system of legal rules designed to protect business. The courts' strong *laissez faire* orientation manifested itself in rules making it very difficult for employees to recover from their employers for on-the-job injuries and by developing the concept of *employment at will* as the basic contractual rule governing the employment relationship.

Employment at will basically meant that either party to an employment relationship could terminate the relationship at any time for any, or no, reason. Even employment contracts promising "steady," "regular," "permanent" or "lifetime" employment were interpreted by the courts as creating only an employment at will relationship. Theoretically, both parties to the

employment relationship were being afforded equal treatment, as the courts assumed equal bargaining power between the parties, unlimited mobility on the part of the work force, and unlimited job opportunities for workers. It is, of course, doubtful whether these assumptions were ever realistic, but they were clearly undercut by developments in the latter part of the nineteenth century. Technological advances reduced employment opportunities as machines performed many tasks previously performed by workers and the required increasing specialization of the work force began to restrict employee mobility. The rise of large business organizations after the Civil War produced obvious disparities of bargaining power between business and labor. The labor union movement emerged and began to spread rapidly.

The courts were, at first, slow to respond to these changing social conditions. The labor movement began to make some progress, however, in the legislatures of our most heavily industrialized states as legislators began to react to the inescapable fact that the political balance in their states was shifting. The first worker's compensation statutes and the first unemployment compensation laws were enacted in the early years of this century. Federal statutory encroachments on managerial authority, in the name of protecting employee rights, began in the period following the Great Depression and continue to proliferate unabated to this day. The Norris-LaGuardia Act in 1932 was followed by the Wagner Act in 1935, the Fair Labor Standards Act of 1938, the Equal Pay Act of 1963, Title VII of the Civil Rights Act of 1964, the Age Discrimination in Employment Act in 1967, the Occupational Safety and Health Act in 1970, the Employee Retirement Income Security Act in 1974, and the Pregnancy Amendment of 1978.

Still, employment at will continues to be the basic legal theory governing most employment relationships in the United States today. Although the courts have significantly retreated from most of the unabashedly probusiness, *laissez faire*-inspired rules of tort and contracts that they created in the nineteenth century, they still have been reluctant to discard the employment at will principle. This reluctance is probably chiefly the product of judicial fears of unduly encroaching on managerial authority.

Is employment at will likely to survive this decade? A brief survey of the relevant social factors indicates a strong probability that it will not. The United States is now a nation of employees with ninety percent of its work force falling into the wage earner category. Roughly two-thirds of this work force, including the great majority of managers, labor without the protection against wrongful discharge afforded their more fortunate peers who are protected by collective bargaining agreements, tenure rules, or civil service rules. In our current relatively high unemployment economy the individual consequences of being fired are often disastrous. Many workers have no significant assets and are totally wage-dependent. Fringe benefits like pensions, and health and life insurance are commonly tied to employment. Recent studies delineate the social consequences of unemployment, noting statistical correlations between high unemployment and alcoholism, child abuse, suicide, infant mortality and crime.

Combine these social facts with the realization that every other Western industrialized nation affords workers with some form of protection against wrongful discharge and one is moved to conclude that we are likely to follow. Already, as has been noted previously, the trend to restrict managerial discretion in matters of employment is plainly apparent in statutory encroachments on managerial authority. Terminations based on union activities, age, race, sex, national origin, religion, complaints to OSHA and pregnancy have been severely restricted. There are also numerous indications that the courts are in the process of a similar piecemeal erosion of the employment at will idea.

Many courts have recognized an employee

right to sue in tort for abusive discharges that are contrary to some clearly expressed public policy. Thus employees who have been fired for refusing to perjure themselves before legislative committees at their employer's behest,[2] for filing a worker's compensation claim,[3] for refusing to avoid jury duty,[4] and for refusing to take part in illegal price-fixing[5] have been granted recovery against their employers.

Similar signs of change are appearing in contract cases. Thus, one court found an implied contract right not to be discharged except for just cause existed for a long-time employee who had recently moved his family to another state at his employer's request.[6] In another instance, an employer's promise to pay one-half the moving expenses of a store manager trainee as soon as employment commenced and the balance after one year was held to create an implied contract for one year's service and nót employment at will.[7] Similarly, a Michigan court recently found that employer assurances that employees would be retained "as long as you're doing the job" gave rise to a contract right not to be discharged except for cause.[8]

The New Hampshire Supreme Court, in *Monge* v. *Beebe Rubber Company*,[9] has gone so far as to recognize a contract right in all employment contracts against bad faith or malicious terminations. Noting that the law governing the employment relationship has "evolved over the years to reflect changing legal, social and economic conditions,"[10] the court concluded that "the employer's interest in running his business as he sees fit must be balanced against the interest of the employee in maintaining his employment, and the public's interest in maintaining a proper balance between the two."[11] Although *Monge* falls short of adopting a full "just cause" dismissal standard—there is a gray area between bad faith terminations and terminations for less than cause—the thrust of the opinion is unequivocally away from employment at will.

The import of these varied factors has not been lost on some concerned observers. Last year Peter Drucker, writing in *The Wall Street Journal*, predicted the eventual recognition of a property right in employment.[12] Another commentator has suggested a statutory resolution of the issue, arguing that a "good cause" dismissal standard is probably inevitable and that business's best course is therefore to cut the best deal it can by accepting such a standard in exchange for a drastic limitation in the number of forums in which a wrongful discharge claim can be brought.[13] This would be desirable, for, as he observes, under present law "[a] politically active, elderly handicapped black woman might bring charges against a company in four or five different forums under eight or nine different theories."[14] In fact, one desirable consequence of a "good-cause" standard might be a decrease in the number of employees charging racial or sexual discrimination, as many such claims may in reality result when employees who feel they have been dealt with unfairly pursue the only legally available avenues of challenging their former employer's actions.[15]

However, the likelihood of such a statutory resolution in the near future is at best uncertain. The current political climate and the fact that many people in business are likely to instinctively oppose a statutory "good cause" standard as an infringement on managerial authority means that any such legislation is likely to face formidable opposition. Unions may also resist such legislation if they come to perceive it as a threat to their current role as guarantors of employment security. In the face of legislative inaction, however, increasing numbers of courts are likely to respond to changed social circumstances and retreat from the employment at will standard, which, after all, was their creation.

The informed manager is therefore likely to be confronted with a dilemma: should organizational resources be dedicated to fighting what may be a lost cause, or devoted to preparing to meet the inevitable by adopting more careful

hiring methods and internal due process procedures for dealing with employee terminations? Our historical experience tends to support the latter course.

FOOTNOTES

1. L. Friedman, *A History Of American Law*, at p. 14 (1973).

2. Petermann v. International Brotherhood of Teamsters, 344 P.2d 25 (Cal. 1959).

3. Frampton v. Central Indiana Gas Company, 297 N.E. 2d 425 (Ind. 1973).

4. Nees v. Hocks, 536 P.2d 512 (Ore. 1975).

5. Tameny v. Atlantic Richfield Oil Co., National L.J., June 30, 1980, at p.1.

6. Foley v. Community Oil Co., 64 F.R.D. 561 (D.C.N.H. 1974).

7. Miller v. Community Discount Centers, Inc., 228 N.E. 2d 113 (Ill. 1967).

8. Toussaint v. Blue Cross & Blue Shield, 48 U.S.L.W. 2826 (June 10, 1980).

9. 316 A.2d 549 (N.H. 1974).

10. *Id.* at 550.

11. *Id.*

12. P. Drucker, The Job as Property Right, Wall Street Journal, March 4, 1980, at p. 18.

13. J. Getman, Good-Cause Compromise, Wall Street Journal, August 4, 1980.

14. *Id.*

15. *Id.*

Greater Legal Exposure for the Indiana Seller of Workplace Products

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When the Indiana General Assembly, as part of its last official legislative act of 1978, passed the Indiana Product Liability Act,[1] many manufacturers of workplace products selling in this state breathed a collective sigh of relief. This statute, which purported to restate and recodify Indiana tort law with respect to product liability, also contained three new legal defenses previously unavailable to Indiana manufacturers. These new defenses can be characterized as: 1) the concurrent misuse by an employer (or other third party) defense; 2) the "state of the art" defense; and 3) the ten year from initial delivery repose defense.

First, the act dealt with the situation where an employee's injury is caused jointly by a dangerous defect in a workplace product coupled with the *employer's* misuse of the product.

Under state law, generally, the employee not only can recover workers' compensation from his employer but he is also free to sue the product manufacturer under product liability theories and may recover a judgment that may be many times the limit provided for in the worker compensation statutes. If the employee does recover from the product manufacturer, however, the employer can take back from the employee's award what he has paid out to him in workers' compensation payments leaving the product manufacturer to foot the entire bill. The new statute, provides that the employer who *misuses* the product may no longer recover his workers' compensation payments when he and a manufacturer of a defective workplace product are both adjudged to have caused the worker's injuries. Of course, the product manufacturer must prove that the employer was a product misuser.

The second new defense becomes available when a product is designed "in conformity with the generally recognized state of the art at the time the product was designed or manufactured," and the design is responsible for the physical harm. The term "state of the art," has generally been interpreted by courts to mean what was technologically feasible—not what was the industry practice—at the time of manufacture or design. This defense probably provides substantially less protection to the seller than is generally supposed.

The third defense is the centerpiece of the statute. It is generally called a repose provision, which in the Indiana act appears to cut off the manufacturer's liability between ten and twelve years after a product is initially delivered to a user or consumer. Although the provision is clumsily worded, it was clearly intended to be an "outer cutoff" of liability and it promises to have some impact on workplace product liability where products, such as machine tools, are generally long-lived. Prior to this statute's enactment the manufacturer's exposure to strict tort liability was open-ended if the plaintiff could prove that the product was defective in design, manufacture, or deficient in warnings and instructions when it originally left the manufacturer's control. Often the sheer uncertainty generated by such open-ended liability was sufficient to increase product liability insurance rates by a "fudge factor" because actuaries were unable mathematically to assess the risks.

It was the escalation—indeed the explosion—of liability insurance rates in the 1970s that motivated Indiana manufacturers and their insurers to press for legislative relief. A number os smaller Indiana manufacturers in high- and medium-risk industries testified before the legislature that product liability insurance had become virtually unobtainable and, if obtainable, was certainly unaffordable, sometimes rising two and three thousand percent within a two- or three-year period.

This rocketing of insurance rates can be traced to a number of factors, but the rapidly increasing frequency and size of product liability judgments, as well as settlements out of court, were certainly the most significant causes. The surprise to the insurance industry generated by this developing judicial trend, coupled with uncertain actuarial projections for the future, probably led to some panic pricing of product liability insurance lines in the 1970s. But what has been branded by some as insurance industry overreaction may turn out to be fully justified if a recent series of Indiana cases are considered, notwithstanding the protections promised manufacturers by the new Product Liability Act.

In 1977, the Seventh Circuit Court of Appeals, deciding *Huff* v. *White Motor Corp.*,[2] under Indiana law, abandoned an earlier position it had held for eleven years that had greatly favored product manufacturers. The court in *Huff* ruled that the manufacturer must now foresee the ordinary environment in which its product (in *Huff*, a truck) will function, and if that ordinary environment includes frequent collisions or other calamitous events, the manufacturer must provide a reasonable measure of

protection for the user even if the collisions or calamities were caused by the user or by third parties. This "crashworthy" requirement was supported by a duty found in 1976 by the Indiana Court of Appeals in *Gilbert* v. *Stone City Construction Co.*,[3] that a product manufacturer must employ feasible safety devices, if available, and the failure to do so will make its product defective. Indiana courts in these two cases were recognizing the manufacturer had some duty to protect the user from uses of the product that the manufacturer neither desired nor intended. These courts stopped short, however, in *Huff* and *Gilbert*–temporarily at least–of declaring that the manufacturer had a duty to anticipate or foresee conduct that could be characterized as product "misuse."

While the manufacturer's duty to protect the unwary, unfortunate, or even negligent product user from the consequences of fate, or his own carelessness, was being heightened by judicial decision, the courts were simultaneously limiting the user's duty to protect himself. The negligent failure of a product user to discover a defect in a product that he should have discovered was eliminated as a bar to his recovery in 1970 when Indiana adopted the legal theory of strict liability in tort, but a risk a user or consumer was aware of, or one he *should have* been aware of, and which he unreasonably incurred, was sufficient to defeat his claim until 1978. In that year, however, in *Kroger Company* v. *Haun*,[4] the court opted to follow the majority American rule that requires a defendant to prove that the plaintiff was *in fact* fully aware and appreciative of the unreasonable risk he was voluntarily incurring before the defendant would be granted the benefit of a defense.

This "incurred risk" defense has traditionally been given a wider sweep in the workplace. A nineteenth century rule had held that, as a matter of law, a worker voluntarily incurs, through an implied contract with his employer, the risk of ordinary hazards of the employment he accepts as well as the extraordinary risks of which he later receives notice. That doctrine was shrunk substantially for Indiana in 1978 in *Meadowlark Farms* v. *Warken*,[5] to include only the ordinary risks of employment, and in 1980, in *Bemis Co.* v. *Rubush*,[6] the rule was for all practical purposes held not to apply to strict liability actions, a holding that virtually destroys its viability.

The *Bemis Co.* case dealt a fatal blow to yet another defensive doctrine that had served to insulate workplace product manufacturers from a number of Indiana product liability judgments. Indiana cases had stated that a party could not recover if the danger which causes his injury was open and obvious. Clearly, the plaintiff could not be heard to argue, for example, that he had not been *warned* of the danger when anyone might see that a power saw would cut off the fingers of anyone who stuck his hand in it. Yet in jurisdiction after jurisdiction courts have decided that the open and obvious danger rule should not go so far as to relieve the product manufacturer of *guarding* the user, even from obvious danger, if it were feasible to do so. In *Bemis Co.*, the court recognized this duty existed for the Indiana manufacturer and it held that although obviousness of danger might be an important factor to consider it would no longer be an absolute bar to recovery.

Indiana courts recognized early that there was a duty to warn users of hidden dangers, but only recently have they scrutinized the adequacy of those warnings. In 1980, in *American Optical Company* v. *Weidenhamer*,[7] the Indiana Court of Appeals, reiterated a rule that stated that an inadequate warning is equivalent to *no warning* and a warning that is deficient as to either form or content will be found to be inadequate. A warning printed in 1/32" type was held in the *Weidenhamer* case to be inadequate in form because other words printed on a package of industrial safety glasses that seemed to imply that the glasses were impregnable were printed in significantly larger type.

The warning that stated that the glasses were "NOT unbreakable" was also held to be inadequate as to content because the message failed to disclose that the glasses might shatter into jagged pieces.

The duty of the manufacturer to deal with unintended use, or misuse, of his product was heightened significantly by the Indiana Court of Appeals in *Conder* v. *Hull Lift Truck, Inc.*[8] The manufacturer of a lift truck, Allis Chalmers, was ordered to go through another trial because it may have failed to warn the mechanics employed by its customer, leasing agent Hull, that the governor-carburetor linkage of its lift truck could be misadjusted, and that the misadjustment might lead to the throttle sticking open, if at the same time a torsion spring, which was a backup device, were also to fail. It did not matter that, when this improbable scenario actually occurred, the employer of the injured plaintiff became aware of the malfunction, yet failed to remove the unit from service, failed to inform the leasing agent, failed to fix the unit, and failed to warn the plaintiff operator, who, as a result, was badly injured. The court recognized that the lift truck had been misused by the leasing agent's mechanic, but it held that the manufacturer had a duty to foresee such misuse if it could, and to warn or guard users from the consequences of the misuse if it were feasible to do so.

The duty to warn users in the workplace has generally been held to be discharged in Indiana if the product manufacturer warns the employer; the duty then to warn the employee shifts to him. While this rule was recently acknowledged by the Indiana Court of Appeals in *Shanks* v. *A.F.E. Industries Inc.*,[9] the court held that an *additional* duty to warn users by means of a built-in warning safety device, such as a bell or siren, might also reasonably be found by a jury to exist, and a trial on that issue was ordered. The Indiana Supreme Court reversed that decision on the ground that a physical warning device was not so clearly an effective solution to predictable safety problems from the perspective of the original design of this product (which was a grain dryer later incorporated by others into an automated complex) as to permit a jury to speculate that its omission was a product defect. The supreme court did not, however, reject the principle advanced by the court of appeals that additional physical warnings might be required from the original manufacturer in cases where it can be proven they will be effective and feasible. Nor did the supreme court attack the appellate court's holding that a manufacturer of a component of a larger product was just as subject to a product liability suit as the final assembler.

It should be noted that at this writing the *Bemis Co.*, *Conder*, and *Weidenhamer* cases are still pending, either for rehearing by the Indiana Court of Appeals, or for transfer to the Indiana Supreme Court. It should also be mentioned that not all of the recent Indiana cases have been expansive with respect to manufacturer's liability. In several cases, statutes directed at other classes of defendants such as employers were not extended to reach product manufacturers. In another case legal causation was not expanded to include remote causes as sources of liability, and the "concept of delivery" was required before strict liability could be applied in two others. In still another warranty case, decided under the Uniform Commercial Code, an injured party not living in the same household as the product purchaser was not permitted to sue the product manufacturer for breach of warranty.

On balance, however, the recent trend in courts deciding under Indiana law has been to expand the scope of the strict product liability theory. This theory does not go so far as to make the manufacturer an insurer whenever his product is involved in an accident, but it does make the reasonableness of the manufacturer's *conduct* irrelevant. Instead, strict liability focuses on the defective *condition* of the manufacturer's products. While the theory was adopted in response to pressures for greater

consumer protection, an arena for substantial litigation has developed with respect to workplace products. Of fifteen Indiana product liability cases recently surveyed, twelve involved workplace products. Nationally, nearly half the product liability dollar payout goes to injured worker-users–not consumers.

Injured workers, as we have noted, recover automatically from the state worker compensation systems. The limits to worker recovery, however, in many states, Indiana included, are arguably inadequate. It has been suggested that because the product liability tort litigation system is extremely wasteful and uncertain, it does not really serve the interests of injured workers as well as would an augmented and reformed workers' compensation system. This suggestion leads to the conclusion that the amounts spent on workplace product liability judgments and settlements, together with the excessive friction costs that they generate, should be systematically diverted somehow to the workers' compensation fund. This writer believes this suggestion should be carefully examined and debated.

In conclusion, it should be noted that even the protections offered product sellers by the Indiana Product Liability Act of 1978 may not be all that secure. The statute was vigorously attacked recently in federal court in *Dague* v. *Piper Aircraft Corp.*[10] Plaintiff in that case, whose husband was killed in an allegedly defective thirteen-year-old airplane argued that the statute's ten-year repose provision removed a remedy to which she was entitled under the Indiana Constitution. She also claimed that the statute only benefits a special class of defendants, i.e., product manufacturers, that it discriminates against "old-product users," and that it was enacted as a rider to a court jurisdiction bill in violation of the Indiana Constitution's one subject rule. The statute survived all these challenges at the trial level, and on appeal, but other provisions of the statute will certainly require judicial interpretation in the future.

Footnotes

1. Indiana Product Liability Act of 1978, Ind. Code. 33-1-1.5-1 to-8 (Supp. 1980).

2. Huff v. White Motors Corp., 565 F.2d 104 (7th Cir 1977).

3. Gilbert v. Stone City Const'r Co., 357 N.E. 2d 738 (Ind. Ct. App. 1976).

4. Kroger Co. v. Haun, 379 N.E. 2d 1004 (Ind. Ct. App. 1978).

5. Meadowlark Farms v. Warken, 376 N.E. 2d 1212 (Ind. Ct. App. 1978).

6. Bemis Co. v. Rubush, 401 N.E. 2d 48 (Ind. Ct. App. 1980).

7. American Optical Co. v. Weidenhamer, 404 N.E. 2d 606 (Ind. Ct. App. 1980).

8. Conder v. Hull Lift Truck, Inc., 405 N.E.2d 538 (Ind. Ct. App. 1980).

9. Shanks v. A.F.E. Indust. Inc., 403 N.E. 2d 849 (Ind. Ct. App. 1980), Rev'd, 416 N.E. 2d 833 (Ind. 1981).

10. Dague v. Piper Aircraft Corp., No. 599-293 (N.D. Ind., May 27, 1980), appeal docketed, No. 801938 (7th Cir. June 26, 1980), Four questions cert. to Indiana Supreme Court answered 401 N.E. 2d 207 (Ind. 1981), affm'd, No. 80-1938 (7th Cir. Apr. 17, 1981).

The Constitutionality and Application of the Indiana Product Liability Act

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During the last decade manufacturers were increasingly subjected to product liability suits, escalating awards, and spiraling insurance premiums. While the spiraling premiums were in part a response to the increases in suits and awards, they were in large part attributed by the insurance industry to be the result of inability to predict risks because of the open-ended nature of liability for products. As long as a product is in use, the manufacturer is subject to liability if that product injures someone. In some instances, manufacturers were held liable for products sold twenty to thirty years earlier. In an effort to control this open-ended liability and to stabilize the increases, the Indiana legislature in 1978 passed the Indiana Product Liability Act. Indiana joined over a third of the states in passing such legislation and in making a statute of repose the primary vehicle for alleviating the problem. Since statutes of repose set a definite time limit after which no suit can be brought, they bar most old-product suits and make risks more predictable.

Concurrent with this legislative trend toward protective legislation has been a countervailing trend in some courts to expand traditional tort concepts to facilitate product liability lawsuits, especially those based on time-delayed injuries from products. Time-delayed injury suits, involving products such as asbestos, Agent Orange, and DES and other drugs, are increasing by the thousands, and it has been predicted they will dominate tort law in the 1980s. Therefore, an increasingly important question is whether the statutes of repose will be found constitutional in the delayed injury context, and whether, if constitutional, they will be interpreted in such a way as not to time-bar such suits. It is not clear what the Indiana courts will do.

Under traditional tort law an individual injured by a product must bring suit within a stated period of time, usually two years, after the cause of action accrues. In the usual situation accrual would begin when that individual was injured by the product. Because of this two-year accrual statute of limitations, suit could be brought against the manufacturer of a product as long as that product was in use. Statutes of repose were designed to stop this open-ended liability by setting a definite time period—ten years in Indiana—after which suit could not be brought. Under the Indiana statute the ten-year period begins to run after the delivery of the product to the initial user or consumer. Therefore, if a person is injured by a product twelve years after delivery, that individual, on the face of the statute, would not be able to sue.

Statutes of repose have been challenged on the constitutional grounds that they deny equal protection and due process of law. The federal and state constitutions, consonant with the basic notion of equality, demand that the laws treat similarly situated people the same unless the state can show good cause for differentiation, and that rights and property cannot be taken away without due process of law. A law that denies protection to people injured by old products but allows those injured by newer products to sue, that protects manufacturers of old products but not new, that gives certain tort defendants greater protection than others is challengeable on equal protection grounds. Likewise, statutes of repose that take away an injured person's right to sue because they expire before the person can become aware of the injury are challengeable on due process grounds as well as state constitutional guarantees of redress for injury. A constitutional challenge to the Indiana statute was recently defeated when the Seventh Circuit Court of Appeals, in the case of *Dague* v. *Piper Aircraft Corporation*,[1] upheld the finding of constitutionality by the District Court for the Northern District of Indiana and the Indiana Supreme Court.

The courts in *Dague* recognized a strong presumption of constitutionality for legislative acts and the legislature's right to change the common law to reflect changes of time and circumstances. They found that Indiana's change to a ten-year repose period did not violate article one, section twelve of the Indiana Constitution, which states, "All courts shall be open; and every man for injury done . . . shall have remedy by due course of law." Since plaintiff had no vested right in a common law action or a fundamental right claim, the only requirement was that the change and the distinction it made not be arbitrary. The court found the ten-year cutoff period was a reasonable legislative response to the perceived pressing problem of the ever increasing number of product liability claims, and would ultimately hold down seller's business costs and therefore the cost of the product to the public.

While not recognized by the court, there are additional facts that support the finding that the classification is not arbitrary. More than 97% of product liability suits are reportedly based on injuries caused by products six years or less old.[2] Thus the ten-year period allows the overwhelming majority of product liability suits to be brought. Assuming the legitimacy of some cutoff period (and similar limitation periods have been recognized for architects' and builders' liability, as well as for doctors and health care providers), the ten-year period seems reasonably related to the goal of providing an actuarially certain date while protecting injured plaintiff's rights. Indeed, ten years is the period most often selected by the state legislatures who have passed statutes of repose. While a more reasonable distinction could be made—for example a relatively short period of years for noncapital goods and a long period, if any, for capital goods, which are often designed to last many years and which account for a majority of older-product injuries—the legislature does not have to make the best choice, merely a rational one.

Dague involved an old product (a thirteen-year-old plane) and the court's discussion of the statute's constitutionality centered around distinctions based on old products that injure. In the recent cases involving asbestos, DES (the generic antimiscarriage drug that allegedly causes cancer in the offspring of the ingestor), Agent Orange, toxic waste, and similar products, the individual is not injured by the use of an older product; it is the injury itself that is "old" by the time it manifests itself. The modern trend under the usual two-year statute of limitations has been to start accrual of the two-year period when the injured person discovers or could have discovered the injury. In cases of delayed injury manifestation, this could be several years after the use of the

product. Since the Indiana Product Liability Statute changes the open-ended two-year accrual time, it would appear, on the face of the statute, that an individual who does not discover his or her injury until more than ten years after obtaining the product would not have a cause of action. However, analogous precedent in Indiana indicates this may not be so.

The closest analogous situation in which there have been decisions is under the medical malpractice statute of repose. That statute, which predates the products liability statute and was similarly passed to solve a perceived crisis caused by an increase in the number and amount of malpractice suits, states that suit must be brought within two years "from the date of the act, ommission or neglect complained of." It is, in other words, a time-of-occurrence statute that requires the two-year period to begin running at the time the doctor acted, and not at the time the injury is discovered. Despite this clear language, the Indiana Court of Appeals stated in *Alwood* v. *Davis*,[3] that the statute's language may have to be construed to mean within two years from the time of discovery of injury in order to have the statute's constitutionality sustained. Similarly, the products liability statute of repose may have to be reinterpreted to save its constitutionality in those cases in which product-related injuries do not manifest themselves until after ten years. Indeed, a recent decision in Florida overturned that state's twelve-year product liability statute of repose on similar grounds in a case involving such a time-delayed manifestation. In *Diamond* v. *E.R. Squibb & Sons, Inc.*,[4] plaintiff's mother took DES in 1956, but plaintiff did not discover injury until 1976. The Florida Court of Appeals found that the statute barred plaintiff's suit, but the Supreme Court said the statute could not be sustained.

It is arguable that the legislature did not intend to include these kinds of situations under the coverage of the Act. Such cases were generally not in the minds of the legislators when they deliberated and passed the Act. Attention was primarily focused on old-product suits and the actuarial uncertainty they created. Therefore, the court could find that the legislature did not intend the statute to apply to delayed manifestation injuries and could more easily find that an accrual at discovery limitation should be used.

A different argument, which would also allow some delayed manifestation suits to circumvent the statute, is based on a theory of estoppel. Traditionally if a defendant fraudulently conceals facts or information and thereby prevents a plaintiff from learning of an injury, or that he or she has a cause of action, the defendant is estopped from using the statute of limitations as a bar to the suit. The Indiana Product Liability Act is silent as to this occurrence but assumedly estoppel would apply to the repose period as it does to other statutes of limitations. In the DES cases, as in many of the other delayed injury suits, part of plaintiffs' claims are based on the allegation that defendants knew or should have known that the product was dangerous, but kept that information from the buyers and continued to advertise and market the product. Because of the nature of the injury, delayed manifestation, product-related injuries generally involve a time lag between the discovery of the cause and effect and general public knowledge. Therefore the seeds of an estoppel argument are planted in most delayed manifestation cases and may prevent the defendant from using the ten-year limitation to bar the suit.

The Indiana Supreme Court, in answering the certified question from the Seventh Circuit in *Dague* regarding interpretation of the Act states, "The Products Liability Act expressly applies to all product liability actions sounding in tort, . . . and the legislature clearly intended that *no* cause of action would exist . . . after ten years."[5] Whether the court will find the statute as unequivocal when faced with a

plaintiff whose suit was barred before injury was known is problematic. There is increasing evidence that the "crisis" the statute was designed to cure was caused not so much by old-product cases as by the insurance industry's overreaction to unverified data. The Interagency Task Force on Product Liability, whose study led to the proposed Model Uniform Product Liability Act, found this to be the case, and the Model Act specifically exempted delayed injury suits from its limitations period.

Additionally, there are indications that recoveries and rates are stabilizing. A recent study by the Rand Corporation shows median jury awards are declining, and there is little outcry today by groups such as the Small Business Administration that a lack of insurance availability is forcing businesses to close or curtail their operations. Therefore, although the same policy reasons that argued for the passage of a repose period apply with equal force to delayed manifestation cases, the diminution of a crisis atmosphere combined with arguments of equity and constitutionality may cause the court to find differently in the delayed manifestation cases.

FOOTNOTES

1. Dague v. Piper Aircraft Corp., No. 80-1938 (7th Cir. April 27, 1981).

2. 1976 Products Liability Closed Claim Survey (Insurance Services Office, New York City (Dec. 1976).

3. Ind. App. , 411 N.E. 2d 759 (1980).

4. [1981] 9 Prod. Safety & Liab. Rptr. 414 (Fla. Ct. App. April 16, 1981).

5. Ind. , 418 N.E. 2d 207, 212 (1981).

Consumer Protection Trends in Indiana Real Estate Law

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One of the most striking legal developments of the past twenty years has been the dramatic elevation of the status of the consumer. In the field of product liability law, mass production and marketing of an increasing number of sophisticated and potentially dangerous products to an increasingly reliant consumer population demanded greater legal protection of consumers to ensure the quality of these products. Courts and legislatures responded by creating new doctrines that made it easier for an injured consumer to recover damages from almost anyone in the distributional chain who played a role in the marketing of a defective product.

These proconsumer developments did not, however, generally apply to the real estate industry until relatively recently. The doctrine of *caveat emptor*—"let the buyer beware"—reigned in the real estate law of Indiana and most other states. This meant that a person who sold or leased real estate had no legal

obligation to deliver the property in a habitable condition unless he had expressly promised to do so.

If courts were slow in perceiving the need for greater consumer protection in real estate transactions, it was due in part to the fact that mass production and mass marketing are fairly recent phenomena in the real estate industry, and in part to the well-entrenched view of the seller-buyer and landlord-tenant relationships as arm's length transactions between equals.

The *caveat emptor* rule had presumed a self-reliant buyer or tenant who was capable of inspecting property, discovering any defects, and protecting himself against any defects by bargaining for favorable deed provisions. This view of the self-reliant consumer originated in the sixteenth century, a time in which land was the basis of the economy and agriculture was the predominant use of land. Legal doctrines envisioned the sale or lease of pastoral, undeveloped property rather than the tract home or the high-rise apartment building. The average buyer or tenant of this earlier day was a self-sufficient yeoman farmer who bargained primarily for the right to use the land and reap its fruits. The use of any structures on the land was incidental and the buyer or tenant was generally able to make repairs of these relatively simple structures himself. The traditional *caveat emptor* rule may have been perfectly satisfactory in a stable, rural, preindustrial society, but when considered against the realities of modern life, tension becomes apparent.

The population shift from rural villages to urban centers after the Industrial Revolution elevated the importance of the buildings on the land. The number of farmers decreased and the urban population bought or leased property primarily for shelter rather than for agricultural purposes. The average buyer or tenant was no longer self-sufficient. Complicated modern buildings required more maintenance at a greater cost and the increasingly mobile consumer had neither the means nor the expertise to discover latent defects or to make necessary repairs. Many homes were mass produced rather than custom-built, so that the typical buyer or tenant had even less knowledge of and control over the quality of construction. The shortage of affordable housing further lessened the buyer's alternatives. It was no longer realistic to presume that the inexperienced buyer of today could be on an equal footing with a builder who was daily engaged in the business of building and marketing houses. Rather, courts began to view the relationships of seller to buyer and landlord to tenant as unequal ones between a relatively ignorant and dependent population of housing consumers and a relatively knowledgeable, professional class of sellers. As compared to the average buyer or tenant, the professional builder-seller or landlord is likely to have a greater opportunity to prevent, absorb, and redistribute losses resulting from latent defects.

The tension between the needs of a new type of consumer population and an outdated body of law culminated in steps by Indiana courts and those of most other states to shore up the bargaining power of housing "consumers." State courts are gradually granting protection to the real estate consumer equal to that of the consumer of personal property. A series of Indiana cases decided in the past decade indicates that Indiana is in the mainstream of this trend.

SALE OF RESIDENTIAL HOUSING

New Homes

Prior to 1972, Indiana observed the rule that absent fraud or express warranty a seller of real estate (even a seller of a new house) had no obligation with respect to the quality of the property.[1] In the 1972 case of *Theis* v. *Heurer*,[2] however, the Indiana Supreme Court abolished this traditional legal immunity for the builder-seller of a new home.

In *Theis*, home buyers sued the builder-seller of their new home because the placement of sewer lines and drain tile around the house caused water and sewage to back up and collect in the house during rainy periods. Had the court merely followed Indiana precedent it would have refused to impose liability on the builder-seller. Deciding that the *caveat emptor* rule as applied to new houses was out of step with modern real estate marketing and buying practices, however, it chose to overrule the precedent.

The court noted that the *caveat emptor* rule poorly served the industry itself, lending encouragement to the unscrupulous purveyor of shoddy work. It was also impressed with the need to make consumer protection in real estate transactions consistent with consumer protection in personal property sales transactions. It cited approvingly an Arkansas court that had noted:

> ". . . there is nothing really surprising in the modern trend. The contrast between the rules of law applicable to the sale of personal property and those applicable to the sale of real property was so great as to be indefensible. One who bought a chattel as simple as a walking stick or a kitchen mop was entitled to get his money back if the article was not of merchantable quality. But the purchaser of a $50,000 home ordinarily had no remedy even if the foundation proved to be so defective that the structure collapsed into a heap of rubble."[3]

After deciding that *caveat emptor* reflected social conditions no longer present in Indiana, the Indiana Supreme Court substituted the implied warranty of habitability. This warranty imposes the obligation to deliver property in a condition suitable for human habitation. It does not guarantee that the house will be perfect or free from all defects, but it does give the buyer the right to rescind the sale and to sue for damages if there are major defects that cannot be easily remedied and that render the house unfit for human habitation. Presumably, the buyer could recover the cost of necessary repairs. Since the warranty of habitability is an implied contractual undertaking on the part of the seller, the buyer's ability to recover damages does not depend on the seller's knowledge of the defect, or even on the seller's negligence in causing the defect. Rather, the focus is on the condition of the house.

In *Theis*, Indiana joined the ranks of the majority of states that now recognize the implied warranty of habitability. Since the *Theis* decision involved *first* purchasers of a *new* home from a *builder-vendor*, however, it was a potentially narrow decision. Litigation in the ensuing years tested its breadth as a precedent by testing what classes of real estate consumers are protected by the implied warranty of habitability.

Used Homes

If Indiana entered the mainstream of modern legal thought by recognizing the implied warranty of habitability in *Theis*, it soon moved ahead of the pack in the 1976 case of *Barnes* v. *Mac Brown & Co.*[4] Whereas *Theis* had involved a lawsuit between two parties to a contract, *Barnes* involved a suit between two parties who had no contractual relationship.

In *Barnes*, the plaintiffs bought a four-year-old house from the Shipmans, who had purchased it new from the builder. After moving into the house, the Barneses discovered that the basement leaked and that there was a large crack around three of the basement walls. It cost $3,500 to repair the basement. The Barneses sought compensation from the original builder-vendor.

The issue before the court was whether the builder-vendor's implied warranty of habitability would extend to subsequent purchasers. Most courts have refused to go beyond impos-

ing the warranty of habitability on new homes sold by the builder. Few have extended the application of the warranty to used homes, even to those recently built. Because implied warranties are contractual in nature, the application of implied warranties in real estate transactions has generally been limited to the original parties to the contract. Underlying this limitation is the fear that a builder-vendor may remain subject to liability in perpetuity and may suffer liability for problems in a used home more related to the age of the house and normal wear and tear than to a defect that the builder could have prevented. Limiting the extension of warranty protection to the original purchaser has served as a convenient and easily applied cutoff point for courts. The Indiana Supreme Court, however, found the rationale of *Theis* equally applicable to subsequent purchasers.

The standard to be applied in determining whether there has been a breach of warranty is one of reasonableness in light of all the surrounding circumstances. The buyer must prove the existence of a defect that could not have been discovered through a reasonable inspection, which manifests itself after the purchase. A court will consider numerous factors to determine whether the warranty has been breached, such as the age of the house, the use to which it had been put, and its maintenance.

The extension of warranty protection to second buyers of used homes in *Barnes* represents a minority position that is followed by only a few other states. The limits of this doctrine were tested in the 1980 case of *Vetor v. Shockey*.[5] The Shockeys purchased a four-year-old home from Vetor, who had lived in the house for four years, but had not built it. When the toilets and the washer malfunctioned during rainy periods the Shockeys sued Vetor for breach of the implied warranty of habitability. The Indiana Court of Appeals refused to impose a warranty of quality on a nonbuilder of a used home. Whereas the public interest may be served by shifting repair or replacement costs to a builder who created the defect and is in a position to control the quality of construction and warn of any defects, the court decided that it is not served by imposing liability on a nonbuilding seller of a used home. In these circumstances the seller is not likely to have any greater expertise than the buyer. If the buyer is to recover in such a case, he must be able to demonstrate misrepresentation or fraudulent concealment on the part of the seller.

LANDLORD-TENANT

Traditional landlord-tenant law treated a lease as a conveyance of land, and assigned few obligations to the landlord. The landlord had the duty to turn over possession to the tenant and to refrain from interfering with the tenant's possession, but that was the extent of his duties. He made no implied warranties concerning the fitness of the premises for habitation, he had no inherent duty to make repairs and he suffered no liability if there was injury to the tenant or anyone else on the leased premises. Furthermore, so long as the tenant was not deprived of *physical* possession of the land, his obligation to pay rent was absolute, no matter how miserable the conditions of the leased premises might be.

The same social and economic forces that had caused the downfall of *caveat emptor* in sales transactions compelled change in landlord-tenant law. A 1971 case, *Weaver v. American Oil Co.*,[6] sounded the death knell of *caveat lessee* in Indiana, when the Indiana Supreme Court refused to enforce a fine-print exculpatory clause in a form lease on grounds that it was "unconscionable." The court made the statement that *"caveat lessee is no more the law than caveat emptor."* [7] It was several more years, however, before Indiana law recognized any inherent duty on the part of a landlord to lease housing that was safe and suitable for human habitation.

In 1976 the Indiana Court of Appeals considered *Old Town Development Co.* v. *Langford.*[8] Langford and his family had leased an apartment in a forty-unit apartment complex from the defendants. A fire broke out in the apartment one night. Langford was injured, his wife and children were killed, and all the contents of the apartment were devastated. Evidence showed that the fire was caused by the builder's placement of a furnace flue vent too close to combustible materials. Langford sued Old Town, basing his complaint on breach of the implied warranty of habitability, negligence and strict liability in tort.

The Court of Appeals noted that the lease has been gradually transformed from a conveyance of land to an essentially contractual relationship, and that the application of the implied warranty of habitability in the landlord-tenant relationship was but a logical extension of the principles of *Theis, Weaver* and *Barnes.* When a landlord rents an apartment for residential use, he impliedly warrants that the leasehold is free of any latent defects that render it unfit for residential purposes and also that it will remain reasonably fit during the term of the lease. Breach of this warranty, said the court, renders the landlord liable for a full range of contract damages including damages for personal injury and property damage.

The *Old Town* court had said that this warranty was a duty "mutually dependent" with the duties of the tenant. That principle was further developed in the recent case of *Breezewood Management Co.* v. *Maltbie.*[9] In *Breezewood,* two Indiana University students leased an apartment in an older home for $235 per month on a one-year written lease. There were many defects in the apartment, including over fifty violations of the Bloomington Housing Code. These defects remained largely uncorrected, despite notice from the tenants and the city code officers. One tenant vacated the apartment three months early and refused to pay further rent. The remaining tenant refused to pay more than half the original rent. The landlord sued both for the remaining rent and other charges. The tenants counterclaimed for damages, the return of their security deposit, and an abatement of the rent. The tenants produced evidence to show that the reasonable monthly rental value of the apartment was $50 during cold weather and $75 during warmer weather. Affirming the view of a lease as a contractual relationship, the court treated the landlord's breach of the implied warranty of habitability as the breach of a contractual obligation. The tenants' duty to pay rent was thus conditioned on the landlord's duty to provide a habitable leasehold. The court also refused to enforce an "as is" clause in the lease on the grounds that it was unconscionable. As a result of its breach, the landlord was liable to the tenants for the difference between the value of the apartment as warranted and rental value of the apartment in its defective condition. The landlord wound up owing the tenants a total of $1,030 plus the return of their damage deposit.

SUMMARY

The series of cases from *Theis* to *Breezewood* strongly indicates the commitment of Indiana courts to accord a consumer almost the same degree of protection when he buys or leases residential real estate as when he buys or leases a car or a vacuum cleaner or any other item of personal property. Real property itself is being demystified. The trend is to treat the sale of real estate as if it were the sale of any other expensive product and the lease of real estate as a contract for a package of goods and services. Both sellers and lessors are now expected to convey property that will meet the consumer's reasonable expectations of quality.

The basic purpose of doctrines that increase the legal responsibility of sellers and landlords is to ensure their adherence to a standard of safe housing. In imposing liability for the failure to maintain such a standard, the law

steps in to create an incentive that the marketplace might not otherwise create.

This does not mean, however, that unlimited liability will be visited upon anyone who sells or leases real estate. The implied warranty of habitability in the sale of real estate will not be imposed on the occasional, nonbuilding seller. As in the law of product liability, the subject of this enhanced liability will be the professional in the field, the developer or builder-seller. It is the real estate professional who is more likely than the consumer to have the expertise to avoid defects and the financial resources to bear and redistribute the costs of any injuries that occur. With the goals of loss prevention and redistribution in mind, it is likely that the extension of warranty protection to subsequent purchasers of recently-built homes will continue and will eventually become the law of most other states.

The legal vulnerability of Indiana landlords was greatly increased in the *Old Town* and *Breezewood* cases. The lesson of these cases is that a lessor of residential property risks his profit as well as potentially huge liability for personal injury if he leases property that falls below a standard of decent, safe living conditions. Both cases contain broad language that can be construed as suspending a tenant's obligation to pay rent upon the landlord's breach of the implied warranty of habitability. Rent withholding is an extreme self-help remedy, however, and it is likely that these cases will force the passage of legislation specifying the rights a tenant has to use his rent as leverage to gain a landlord's compliance.

Although these changes in the law have occurred in the past ten years, they reflect a slow process of bringing the law into focus with the realities of modern life. Consumer protection in real estate transactions is the inevitable byproduct of the needs of a mobile, industrial society. As such, the landlord, developer, and builder must be cautioned that the rule is no longer *caveat emptor,* but rather, *caveat venditor*–"let the seller beware"!

FOOTNOTES

1. Tudor v. Heugel, 132 Ind. App. 579, 178 N.E.2d 442 (1961).

2. 280 N.E.2d 300 (1972).

3. Wawak v. Stewart, 449 S.W.2d 922, 923 (Ark. 1970).

4. 342 N.E.2d 619 (Ind. 1976).

5. 414 N.E.2d 575 (In. App. 1980).

6. 257 Ind. 458, 276 N.E.2d 144 (1971).

7. *Id.* at 148.

8. 349 N.E.2d 744 (Ind. App. 1976).

9. 411 N.E.2d 670 (Ind. App. 1980).

New Federalism and Judicial Commitment to the National Interest

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Last year's ripples of anticipation have burst into jubilation among states' rights advocates as President Reagan has made clear his desire to revitalize the role of state and local government. Vowing to end federal interference in local affairs, the new administration hopes to reverse the flow of power and responsibility that has favored the federal level since the Great Depression.

The first step in this new partnership between Washington and the states calls for replacing categorical grants with flexible block grants. Categorical grants have been criticized as stifling local innovation since the federal government specifically dictates the purposes for which the money may be employed. The new block grants, effective October 1, 1981, will allow the various states to determine the priorities for distribution of the funds–something the nation's governors have long urged.

Reagan promises that his "new federalism" will go much farther than the revenue sharing so popular with the Nixon administration, for the block grant approach is seen as just the first step in a dramatic shift in federal-state relations. The President clearly envisions a return of whole functions to the states.

Decentralization of various governmental functions is already under way. During Senate confirmation hearings, Secretary of Transportation Drew Lewis indicated that decisions to increase highway speed limits would be left to the individual states. In the past, the states were threatened with a percentage loss of federal road funds based on the number of vehicles exceeding the 55-miles-per-hour limit.

Indiana's recent controversy with the federal Occupational Safety and Health Administration (OSHA) has provided further evidence of this decentralization movement. The State of Indiana, one of twenty-three states administering its own program under an alternative allowed by OSHA, has been severely criticized for conducting lax investigations since the program's inception in 1974. As a result, in one of the Carter administration's last official acts, the federal agency announced plans to assume control of the state program. However, in keeping with new Labor Secretary Robert Donovan's philosophical commitment to allow the states to control programs like OSHA, the present administration reversed the Carter order.

Organized labor has warned that this new era of cooperation between the state and federal government will seriously undermine enforcement of the law. But the OSHA decision, like the highway speed limit example, has allowed Washington to remove several thorns that have long tormented local officials. And in soothing these wounds they have also allowed the President to pursue another campaign pledge–reducing the federal budget. By return-

ing Indiana's OSHA to state control the federal agency has been able to close three offices and trim its staff in the state from forty persons to eight. The decision to end the national speed limit allows the federal government to eliminate the $24 million used for enforcement of the national limit from the National Highway Traffic Safety Administration's annual budget.

The administration has assumed that the states will accept substantial revenue cuts in return for greater flexibility as to how the money may be spent. But this premise has caused alarm among numerous states' rights critics who already question the President's underlying assumption that state and local governments are more efficient and equitable in the distribution of public funds and services than the national government. Federal grants have been primarily responsible for the significant growth that has taken place in state and local governments during the past decade. Critics query how the states and municipalities, faced by severe dislocations in their budgets, will be able to respond to the demands of their constituents.

Much of today's social legislation was pioneered by the federal government rather than the states. Many groups question the commitment of the various states to continuation of these programs, especially in light of drastic reduction in direct federal assistance. Republicans and Democrats alike have resisted the administration's efforts to combine forty-four education programs with a budget in excess of $5 billion into two block grants. There was serious concern that inner-city and handicapped pupils would be shortchanged if the consolidation were implemented, thereby eliminating federal oversight. While some of this opposition may result from lawmakers' desires to claim continued credit for specific federal aid voted by Congress, the opposition to a return of whole functions to the states is real.

In view of these challenges to the commitment and capability of the states to respond to their constituents' demands, what could be the allure of the states' rights movement? It has been argued that the decentralization thrust is, in fact, an indication of the maturation of our political system. According to the theory, "governmental organization follows a modernization cycle similar to that observable in the organization of markets under the impact of advanced technology and communications: fragmentation followed by consolidation followed by differentiation."[1] After several decades of necessary centralization, people are demanding a more flexible participatory government. Irving Kristol suggests that the impetus behind the swing back to the states stems from a mounting anxiety about the fate of democracy in a mass industrialized society. The resultant upsurge of populism is attributable to the perceived gap separating people from their institutions. Thus there is a recognized need for "visible government" that accentuates the element of "participation."[2] Quite simply, people are trying to capture their lost sense of control by turning back to basic American devices. But with the complexities of modern society there is no turning back the clock; fragmentation will not satisfy the numerous demands of the people.

Recent opposition to proposed community development block grants by small-city advocates places the feasibility of a wholesale return of power to the states into proper perspective. Present plans call for handing to the states all community development grants for cities with fewer than 50,000 people. In the past the small cities worked directly with Washington in dispensing these federal funds. Local officials are now questioning the capacity of state government to efficiently administer the grants. They are particularly concerned that duplication of the administrative mechanism in each of the states will unnecessarily siphon off much of the already dwindling resources.

The infamous Sagebrush Rebellion, looming large in the eleven western states, illustrates

several other weaknesses in a decentralized system that lacks national coordination. The controversy focuses on control over almost 200 million acres of land in the western half of the nation. States' rights advocates have demanded that the property be released from under the control of the Bureau of Land Management—an agency of the Interior Department—to the states. Interior Secretary Watt recently fueled the flames by stating that national parks lacking unique significance should be turned over to the local governments. Former Secretary of the Interior Cecil D. Andrus has derided this movement as a thinly veiled attempt to open up the land to questionable development with a "result [that] would be a thoroughly chaotic legal, economic, and resource management situation for all the Western states." In his view, "[i]t would hobble our national energy efforts and obliterate environmental programs."[3]

Citing both political and economic barriers to proper state management of the land and its resources the antistate forces have demanded continued national control. This leadership is seen as providing a broader perspective; one that would allow the property to be shared fairly among competing users in a complex, interdependent society. They see a coordinated effort, with final decisionmaking focused in Washington, as the best way to guarantee that the land is developed in the interest of community need rather than in response to the pressure of special interests.

The current debate over the much maligned Federal Clean Air Act illustrates a prime criticism of returning too much power to the states. While there has been widespread support among the nation's governors for greater authority over enforcement of the air pollution standards at the state level, some state officials have voiced strong opposition to complete abdication by federal authorities. Particularly the governors of the Northeast, fearing the downwind effect of increased use of coal in the Middle West, want to maintain firm federal control over the establishment of air pollution standards.

Balkanization might well nurture a free rider phenomenon that could reverse much of the social progress this nation has developed. In the pollution area some localities have already attempted to ensure their own air quality by requiring that tall smokestacks be built. The tall stacks prevent local pollution but allow the pollutants to blow over outlying areas. Further, one might expect an intense competition among the states to retain and attract industry. Tax incentives and a plethora of antilabor laws might be used as a lure. However, since recent tax revolts and diminishing federal assistance have already painted a bleak picture for local decisionmakers, drastic curtailment of governmental services might be the final result.

Perceiving the potential rivalries among the states and the increased vulnerability of local decisionmakers to overwhelming pressure from special interests, the judiciary has indicated a willingness to play a vital role in guaranteeing coordination between state and national interests. It does not appear that a Reagan Court will undermine the role of the national government as the coordinator. It is true that the 1980 Republican Party platform called for the appointment of judges whose philosophy "is consistent with the belief in the decentralization of the federal government and efforts to return decisionmaking power to state and local elected officials . . ."[4] But, it should be recognized that today's Court, the Burger Court, was largely fashioned by former President Nixon who nominated four of the current justices. A fifth, Justice Stevens, was appointed by Gerald Ford. These men were selected because of their strong belief in the concept of federalism and "perceptible concern with preserving the identity of the state government as a separate functional entity."[5] Accordingly they should provide an accurate barometer of the judicial climate in the 1980s.

In a series of opinions this avowedly states'

rights Court has displayed a general pattern of broad deference to local governments' programmatic choices.[6] Upholding state laws in areas such as land use controls, public education financing, apportionment, public employment, and obscenity, the judiciary has strongly supported maintenance of the diversity of state and local institutions and interests. To the extent that states' rights advocates demand greater local control in these self-rule areas, they should expect little interference from the courts. However, the Court has shown a greater willingness to intervene when local government interferes with rights defined by Congress, thereby preserving the regulatory supremacy of the federal government. Further, state enactments that unduly burden interstate commerce will be struck down as inconsistent with the best interests of the national welfare.

This point was recently reaffirmed in *Maryland* v. *Louisiana*[7] when the Supreme Court overturned a Louisiana tax on offshore or imported natural gas flowing through Louisiana processing plants on its way to other states. Since the state gave its own people a variety of exemptions that substantially shielded them against the impact of the tax, the Court found it to impermissibly discriminate against commerce. Earlier in the year, in *Kassel* v. *Consolidated Freightways*,[8] the Court invalidated an Iowa regulation that prohibited the use of 65-foot double-trailer trucks within the state's borders. Since the law provided exemptions that allowed double-trailers to service Iowa's border cities, the Court was convinced that the statute was designed to secure to Iowans many of the benefits of large trucks while shunting to neighboring states many of the costs associated with their use.

Both the Iowa and Louisiana decisions indicate that even a states' rights Court will not subordinate the national interest to state and local decisionmakers. The judiciary, while favoring a constructive revitalization of the states, recognizes the key role the national government must play as coordinator in future endeavors. Accordingly, state regulations that are overly burdensome on interstate commerce or that conflict with national programs and policies will not survive judicial scrutiny. For the Court perceives the political and economic impediments to action in a fragmented system and phrases the real issue to be not whether to centralize or decentralize, but what are the appropriate functions of the various levels of government.

Of course, the states' rights movement may be just the tip of the iceberg. The more basic issue may be what is the appropriate function of government itself. Decentralization applied to government, if it is to truly address peoples' demands for control, must be more than another form of federalism. Rather than merely refining intergovernmental relations, the process might lead to a systematic policy of utilizing the nongovernmental institutions of society—the private sector—to implement governmental policies. This notion is already evidenced by programs like the EPA's "bubble concept," which grants businesses greater latitude in deciding how to comply with more generalized pollution standards. One might expect increased variations of these flexible performance standards instead of the narrowly-defined rules. Participation may run even deeper as the democratic form of government penetrates industrial life itself rather than remaining confined to the traditional political institutions. At an extreme, the movement could lead to production and investment decisionmaking by workers and consumers, not by individual capital owners or their managers.[9] Already we have witnessed the popularity of increased employee choice within the corporation in the form of flexible benefits packages. These programs provide employees with real alternatives as they allow people to pick and choose from a variety of benefits within a fixed dollar limit. As such, they address peoples' demands for more control over their lives.

The administration's intention of returning more and more functions to the states should address this growing need on the part of society for responsive institutions. Judicial oversight will assist in coordinating local wants with national needs. But in the future one might expect peoples' clamoring for participatory institutions to move beyond the political realm and further blur the line between public and private institutions.

FOOTNOTES

1. L. J. Sharpe, ed., *Decentralist Trends in Western Democracies* (London: Sage Publications, 1979): 3-4.

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The New Economic Activism of the Burger Court

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A recurrent theme among conservative presidents stating criteria for potential Supreme Court appointees is their fidelity to the text of the Constitution and the intent of its framers. Richard Nixon stressed the need for "strict constructionists" in his 1968 presidential campaign. Reagan spokesmen sounded a similar note in discussing the search for a successor to retiring Justice Potter Stewart. What both were implicitly attacking in making such statements was the freewheeling judicial activism so prevalent during Earl Warren's sixteen-year tenure as Chief Justice. Yet the practice of judicial lawmaking is hardly limited to liberals, and it has characterized the Supreme Court's work ever since the beginnings of the Republic. In fact, two of the most blatant examples of nineteenth century judge-made constitutional law were in the service of business interests. Judicial activism in economic matters was supposed to have ended after the 1930s. But, despite some recent statements about its supposed deference to legislative policy, throughout the past decade the Burger Court has quietly been beginning the practice anew.

The approach advocated by Nixon, Reagan

and many others usually argues that constitutional decisions should be based on the literal text of the document itself, plus the debates and other constitutional history helping to explain the meaning of that text. Failing this, such people would contend, judges should adhere fairly scrupulously to past Court decisions interpreting the Constitution, and should be reluctant to break new judicial ground. This often, but not always, expresses a policy of judicial deference to the other branches of government. An "activist" approach, on the other hand, would tend to subordinate such technical legal considerations to moral commands of a supposedly higher order, changing societal values, the social needs of a particular time, perceptions about the direction of future progress, and so forth.[1] Usually, but not inevitably, such activism goes hand in hand with an expansive view of judicial power. Judges of the latter sort are rarely open about what they are doing, and one reason for this is that the techniques of "strict construction" allow much room for the exercise of discretion. The language of the Constitution is often quite abstract and vague. Aside from expressing some idea of equal treatment for equals, for instance, what does the Fourteenth Amendment's command that "No State shall . . . deny . . . the equal protection of the laws" really mean as applied to a particular legislative classification? Worse yet, strict constuctionist literalism can sometimes promote an "activist" posture toward other branches of government. By its terms, for example, the First Amendment appears to invalidate *all* laws abridging freedom of speech, and "liberal" Justice Hugo Black took just this position for many years.

In addition, the preenactment history of an individual constitutional provision is sometimes quite unclear, and it is not uncommon to see judges employing different portions of that history to reach widely disparate results. Past judicial decisions interpreting constitutional language may somewhat arbitrarily fix its meaning in cases where text and history leave this ambiguous, but it is theoretically possible for a subsequent judge to treat such decisions as "wrongly" decided and to go back to the original sources for his own reinterpretation. More importantly, the process of reasoning by analogy from case to case is an inherently flexible one leaving much room for change over time. Finally, even where text or history provide fairly unambiguous answers to constitutional questions, it is not always obvious that such received wisdom should guide the resolution of a present problem. Unless it is assumed that the framers provided a definitive set of answers good for all time, constitutional change may be necessary to accommodate developments unforeseen in 1787.[2]

Thus, it seems that the "strict construction" approach often cannot work with the promised certainty and predictability, and may not be an appropriate guide for action even where it does. As a result, it also does not provide an adequate basis for explaining the behavior of the Supreme Court. Speaking very generally, the personal predilections of the justices and their identification with certain established interests often go farther toward doing so. Contrary to some contemporary popular mythology, this observation cannot be limited to the Warren Court, and is not solely a twentieth century phenomenon. The nineteenth century Supreme Court was occasionally more than willing to confect constitutional doctrines benefiting business. Two examples should suffice to make the point.

Article I, section 10 of the Constitution states that "No State shall . . . pass any . . . Law impairing the Obligation of Contracts." Although the history of this "Contract Clause" is murky, its broad language was apparently intended to attack a relatively specific problem: post-Revolutionary War, state, debtor-relief legislation severely disadvantaging creditors on private contracts. However, in two famous early decisions–*Fletcher* v. *Peck*[3] and *Dartmouth*

College v. *Woodward*[4]—the Supreme Court headed by John Marshall extended the Contract Clause to include *governmental* contracts, grants and charters. This piece of judicial legerdemain had the practical effect of giving constitutional protection to corporate charters. Since such charters were "contracts" for purposes of Article I, section 10, their "obligations"—the rights and privileges they granted—could not be "impaired" by subsequent state regulation. For this reason, *Fletcher* v. *Peck* and *Dartmouth College* are generally regarded as having given a substantial boost to the infant corporate movement of the early nineteenth century. But their influence should not be overrated: they were only one factor contributing to this growth, and the constitutional protection they afforded corporations was diluted in various ways by later decisions.

A more blatant example of probusiness judicial activism, the "economic" version[5] of so-called "substantive due process", began late in the nineteenth century and lasted until the 1930s. The due process clauses of the Fifth and Fourteenth Amendments prevent the taking of liberty or property from a "person" without "due process of law." Traditionally, the term "due process" has had a largely procedural meaning, requiring that the legal mechanisms used when liberty or property is taken by government meet certain tests of fairness to the individual. It did not set criteria to determine when the legislation could take liberty or property, but only involved the modes by which such a prior determination could be enforced. An example is the requirement of a fair trial or hearing before certain deprivations can occur. Late in the nineteenth century, though, the Court began to interpret due process in such a way as to limit the *purposes* for which the legislature could act to take liberty or property. In this "substantive" view of due process, legislation interfering with liberty or property had to bear some "real and substantial" relation to a valid state purpose. Since corporations were "persons" for constitutional purposes and since "liberty" was held to include freedom of contract, substantive due process often served to check social legislation interfering with agreements between those free and equal contracting parties, the corporation and the individual worker. The Court's invalidation of various minimum wage or maximum hours laws is an example. Such laws, it would proclaim, restrict the contractual liberty of employer and employee alike; and also lack a sufficiently close connection with valid governmental goals such as worker health and safety. Such decisions were obvious instances of nonstrict constructionist judicial legislation. They had little precedent in the prior history of due process, and left the courts to determine what were "valid" governmental purposes and what legislative means possessed a "real and substantial" relation to their fulfillment. They also represented a business-influenced Supreme Court's attempt to stem the rising tide of social legislation. The doctrine was hardly an absolute bar to such legislation, but it was effective often enough to make a difference.

The "economic" version of substantive due process met its end late in the 1930s. Its demise might be attributed to several factors, but surely high among them was the perceived need for increased governmental regulation of the economy during the depression era. At this time, the Supreme Court began its great shift: deferring to the state and federal governments in economic matters, and staking out new ground in the area of personal liberties and individual equality. The latter tendency reached its peak during the Warren era, but it has also continued to influence Burger Court decision-making. That Court's 1973 abortion decision,[6] its increasing constitutional attacks on sex-based classifications,[7] and its tendency to uphold reverse racial preferences[8] serve as examples. But the Burger Court has also quietly begun to assume a more activist posture in economic matters as well, thus beginning a shift away from the Court's forty-year pattern of deference to government regulation of the

economy. Not surprisingly, this has often involved an actual or potential boost to business interests. Three examples will illustrate these points.

In *First National Bank of Boston* v. *Bellotti*,[9] the Burger Court struck down a state law prohibiting corporate spending to influence the vote on referenda not involving the corporation's property, business or assets. Though the full scope of *Bellotti* is as yet uncertain, it obviously affords corporations some constitutional protection when they speak on matters of general public concern. In justifying this, the Court stressed the social interest in free and uninhibited discussion rather more than the expressive interests of the individual corporate "person." Critics of *Bellotti* have been quick to point out that the assets and communications skills possessed by large firms will enable them to dominate the national or local "marketplace of ideas", and thus to achieve a disproportionate influence over public policy. Whether this is correct or not, the decision surely is of *some* benefit to large corporations. And, by extending the First Amendment beyond its prior bounds and erecting a new obstacle to government regulation of business, the Court arguably was acting in an activist fashion in *Bellotti*.

"Commercial speech" such as advertising was generally regarded as not entitled to First Amendment protection prior to the 1970s. Thus, its regulation by government could then proceed with relative impunity. During the 1970s, though, the Court gave commercial speech a qualified form of First Amendment protection, subjecting regulation of advertising to a level of judicial scrutiny falling short of that applied to restriction of "full" First Amendment speech but requiring considerable justification nonetheless. In a few such cases,[10] the Court's new doctrine has apparently assisted consumers by breaking up state-sanctioned schemes of professional group price maintenance. But, though this is hardly much of an issue presently, the doctrine may eventually work to the benefit of corporations by assuring constitutional protection for the techniques by which they help create demand for their products.[11] Fantasizing a bit, the new protection given commercial speech might be useful to business if a Moral Majority-staffed FTC attempted to restrict overt and covert sexual incitations in television and magazine advertising.

Along with economic substantive due process, the Contract Clause had fallen into insignificance by the mid-twentieth century. But in two late-1970s decisions, the Burger Court has made it once again a significant part of the constitutional firmament. In one of these cases, *United States Trust Company* v. *New Jersey*,[12] it struck down New York and New Jersey's repeal of a bistate covenant promising Port Authority bondholders that revenues and reserves pledged as security for their bonds would not be used to subsidize mass transportation. In the other, *Allied Structural Steel Corporation* v. *Spannaus*,[13] it struck down Minnesota legislation requiring that certain corporations terminating operations within the state pay a "pension funding charge" designed to protect the pension expectations of employees who had worked for the corporation for ten years.[14] In a flat departure from prior Contract Clause case law, both decisions imposed very stringent tests of constitutionality for state legislation impairing the obligation of contracts. And under these tests it is the Court that will determine what count as important state interests and what legislation advances them with sufficient force to be constitutional. Both decisions were also more or less probusiness, or at least antiregulation, in orientation. In *U.S. Trust*, the Court explicitly favored bondholder security over the states' asserted need to advance their environmental, energy conservation and transportation policies by promoting mass transit. In *Spannaus*, it clearly valued the employer's limited pension plan contract obligations more than the protection of its employees' pension expectations. Neither decision, though, ap-

proaches the practical impact of economic substantive due process, since the Contract Clause has long been held not to affect legislation occurring *before* creation of a contractual obligation.

As the preceding discussion should suggest, "strict constructionism" is, by itself, neither a viable approach for Supreme Court decisionmaking nor an adequate means of explaining what the Court has often actually done. In particular, the judicial activism that conservatives have attacked over the past twenty years is not simply a Warren Court aberration and has often been used to advance business interests. Such activism, in short, is a game that judges of various policy views have played, and that has benefited different interests at different times. The Court's protection of business concerns has been emphasized here because it now tends to be neglected in public discussion of the judicial role, and because the Burger Court seems intent on reviving the practice. But it has also been argued that among the hidden beneficiaries of Warren Court activism were, for instance, labor, the media and the then-burgeoning public sector.

The preceding discussion should not be read as asserting that *all* of the Supreme Court's decisions can be reduced to the policy views of individual justices or the play of group interests, or that there have been no more or less consistent practitioners of judicial restraint. Nor is it to suggest that it is impossible to mount defenses for such deference. These defenses, though, must avoid too closely identifying restraint with strict constructionist techniques and overestimating the ease and predictability with which constitutional text, history and prior cases can be applied to current constitutional problems. Relatedly, defenders of what have been called the "passive virtues" would probably do well to avoid the escapist ancestor worship that typifies too much of the prevailing reverence for the intentions of the Founding Fathers. It is obviously one thing to draw upon the collective wisdom of a political tradition by judiciously employing the insights of its important spokesmen, and quite another slavishly to follow all of their real or imagined aims. Instead, the defense of restraint should (and often does) stress the problems created by uninhibited activism. Perhaps the most commonly mentioned defect of this approach is its undemocratic character. To the extent that judges second-guess legislation by imposing stringent tests of constitutionality to advance chosen values or benefit favored groups, they usurp what is usually regarded as the legislative function. And ordinarily they do so while lacking any claim to greater competence in deciding the public policy question at issue. Also, giving free reign to judicial predilections tends to undermine the predictability and stability that are central to the "rule of law" ideal. Advocacy of "moral" (as opposed to "legal") judicial decisionmaking must be regarded as severely deficient if it fails to include among the claims of morality judicial consistency and regularity. A policy of promoting justice in the individual case may not advance it systemically.

Such arguments, though, have only intermittently proven efficacious in restraining the Court, and there is little reason to think that they will be more persuasive in the future. As a sort of last resort, apostles of restraint point to the damage that may be done to courts if the public comes to perceive that judges are guided by little else than their group ties and/or their personal views on desirable public policy. The recurrent possibility that Congress will attempt to limit the jurisdiction of the federal courts is an example. But the history of the Supreme Court tends to suggest that this threat is a bit of a paper tiger. In fact, it is often claimed that the public and the legislatures are, if anything, more "result-oriented" than the judges themselves. Thus, all that would seem to be required for the successful practice of activist jurisprudence is a reasonable ability to cloak activist decisions in strict constructionist terms, coupled with a sensitive nose for the movement of

public opinion and the balance of group power. And, in the present climate, this might go a long way toward explaining the Burger Court's recent activism in the economic realm.

FOOTNOTES

1. Some of these considerations, of course, may be inconsistent with each other. Changed social values, for instance, might be deemed immoral.

2. The formal constitutional amendment process is always an alternative possibility, but its difficulty of employment precludes its frequent utilization.

3. 10 U.S. (6 Cranch) 87 (1810).

4. 17 U.S. (4 Wheat.) 518 (1819).

5. Substantive due process has also been employed to advance values of a "personal" sort. The constitutional right of privacy, which is largely based on the due process clauses, is an example.

6. Roe v. Wade, 410 U.S. 113 (1973).

7. *E.g.*, Frontiero v. Richardson, 411 U.S. 677 (1973).

8. *E.g.*, Fullilove v. Klutznick, 448 U.S. 448 (1980); Regents of the University of California v. Bakke, 438 U.S. 265 (1978).

9. 435 U.S. 765 (1978).

10. Bates v. State Bar of Arizona, 433 U.S. 350 (1977) (attorney fee schedules); Virginia State Board of Pharmacy v. Virginia Consumer Council, 425 U.S. 748 (1976) (state ban on price advertising for prescription drugs).

11. However, the special protection given commercial speech will not be available where the regulation merely involves the time, place and manner of its statement; where it is false or fraudulent; and where the transactions such speech proposes are themselves illegal.

12. 431 U.S. 1 (1977).

13. 438 U.S. 234 (1978).

14. In *Spannaus*, the private pension plan in question generally prevented employee pension rights from vesting until well after ten years of employment.

Criminal Liability of Officers and Directors

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An examination of the legal environment of business must include a discussion of the potential exposure to criminal liability of officers and directors as they carry out their duties as agents of the corporation. In this context officers and directors are removed from the relative safety of the corporate organizational structure and face the criminal justice system and its sanctions of fines and/or imprisonment alone. To be sure, it is possible for the corporation to be charged with and found guilty of criminal conduct. However, this discussion will be confined to an examination of the instances of and potential for individual

liability only.

To ignore the threat of criminal liability for behavior carried out in board rooms and executive suites is to ignore a fact of life in corporate America. Historically, criminal sanctions were rarely invoked against officers and directors except in instances of obvious fraud or abuse of the corporate structure. The civil liability that might also attach to conduct carried out on behalf of the corporation was considered a sufficient deterrent to meet social needs. In those instances where criminal liability was found to exist, penalties were often light—the proverbial slap on the wrist. Public sentiment has shifted to the point where minimal penalties for executives are not considered to have sufficient deterrent effect; rather they are considered indicative of the criminal justice system being "soft" on white-collar criminals. In addition, there is an emergent public awareness that punishing the corporation for illegal acts and not the individuals who cause the corporation to act illegally, does not strike at the root of the problem. As a result, state and federal law enforcement agencies are investigating white-collar crime with a vigor not experienced heretofore. Hiring practices, budget commitments, and investigative techniques are being modified within these agencies to accommodate the interest in white-collar crime. It behooves the officer and director, then, to be aware of the potential for criminal liability and to consider its consequences when acting for the corporation.

As a general rule criminal liability is personal to the wrongdoer. Unlike civil liability there is usually no means of spreading criminal liability to other passive entities such as employers or insurance carriers. The wrongdoer must bear the penalty if the punishment and the accompanying deterrent effect are to have any meaning. Criminal penalties are considered the most drastic of legal sanctions and, as such, are meted out deliberatively.

A criminal statute typically sets out a state of mind that the wrongdoer must possess when engaging in illegal activity in order for a crime to have been committed. If a statute defines first-degree murder as the intentional taking of another's life then the prosecutor must prove the state of mind of intent for the act of killing to constitute murder in the first degree. Other states of mind not considered as reprehensible as intent—such as knowledge, recklessness, and negligence—can be found in criminal statutes, and it is liability predicated on these states of mental culpability that this article addresses. The individual who is bound and determined to engage in criminal behavior for his or her own gain using a corporation as the means to perpetrate the crime is beyond the scope of the discussion. Nothing can be said to that individual who is fully aware of the nature of his or her actions, but who chooses to ignore the consequences. Rather, the focus is on the officers and directors who, by virtue of their positions in the corporation, may learn of others' criminal conduct or be in a position to prevent the corporation from committing a crime and what exposure that creates for them.

Utilizing a knowledge standard in most cases the Indiana General Corporation Law provides criminal penalties for officers and directors. One who knowingly issues shares in violation of the corporation law or who knowingly signs or issues a certificate for shares containing a false statement is guilty of a felony.[1] Similarly, a person knowingly violating state securities regulations is guilty of a felony.[2] One who is charged with the duty of maintaining a list of shareholders who fails to do so or one who denies access to the corporate books and records to a shareholder entitled to access may be charged with an infraction.[3] All of these statutes seem to require that the officers or directors have a consciousness about the character of their actions before criminal liability will be imposed. However, it would be unwise to assume that the less one knows about a situation the better the chances of avoiding criminal liability. Abdicating responsibility to a subordinate is not sufficient grounds for plead-

ing ignorance. While officers and directors are justified in relying on experts' reports (an audited financial statement, for example), they are also charged with the duty of making reasonable inquiry into corporate affairs, especially those matters that fall within their own functional areas. A financial officer who signs a statement that the corporation has $1 billion in assets has the means, indeed the obligation, to verify that representation. The excuse that he or she took a subordinate's word for it does not constitute a valid defense. Statutes imposing a knowledge requirement can be brought to bear against the officers and directors who actually knew the statement to be false and those who reasonably should have known it was false.

Consider the case of the president and chief executive officer of Acme Markets. The corporation and the individual were charged with violations of federal food and drug laws. The corporation pleaded guilty and was fined, but the president stood trial on the charges lodged against him and appealed his case all the way to the U.S. Supreme Court.[4] He claimed that he could not be held personally responsible for the rodent infestation in two company warehouses. When he received notification from the federal inspectors of the infestation he was told by corporate counsel that the vice president for the region in which the warehouses were located would remedy the situation. When the inspectors returned several months later they found that the condition of the warehouse was improved but still showed signs of infestation. The criminal charges followed the second visit. The statute under which the corporation and its president, John R. Park, were charged specifically contemplates individual as well as corporate liability. It is a statute that creates a strict liability crime, which is to say no particular state of mind must exist for the statute to be violated. The public interest in assuring wholesome food and drugs outweighs any concern that the defendant be aware of or in some way cause the unsanitary condition. If there are rats in the warehouse the statute is violated without regard to how they got there. In affirming Mr. Park's conviction the U.S. Supreme Court did not seem to be imposing liability on him simply because he was president. Evidence adduced at trial showed that under Acme's bylaws the president had supervisory powers over most areas of the corporate enterprise, including sanitation. He was in a position to have done something about the unsanitary condition upon learning of its existence and did not.

The Court would not require Mr. Park to go to the warehouse and set the traps, but did require something more affirmative than passing the obligation to a subordinate. Perhaps a follow-up to the first communication or the institution of a reporting procedure would have sufficed. Park argued that he must depend on subordinates to carry out his many corporate duties. Considering the strong public policy underlying the statute, the Court was not moved to reverse the defendant's conviction on those grounds. The limits of *U.S. v. Parks* are unexplored. It does stand as a statement that criminal liability will be imposed for failure to exercise the power of oversight, at least in the area of regulatory crimes such as violations of pure food and drug laws.

Perhaps more familiar federal crimes that may be perpetrated by corporate executives are contained in the antitrust and securities laws. Certainly criminal charges brought under these statutes draw attention and notoriety to the defendants. Violations of these acts require a certain mental culpability; they are not strict liability crimes. However, it is not necessary that a defendant intend to commit a crime to be found guilty. Oftentimes the defendant's conduct is motivated by laudable concerns such as a desire to advance in the organization or to increase the firm's profits. Whatever the motives, conduct that is anticompetitive, such as price fixing, or that is violative of the securities laws, such as disseminating misleading information in connection with a purchase or sale of a security, is punishable. All are on constructive

notice of the proscriptions of the statutes. The executive would be well advised to familiarize himself or herself and subordinates with the elements of the antitrust and securities crimes and refresh that knowledge on a yearly basis to prevent the possibility of overzealousness becoming criminal conduct.

In addition he or she must always consider the legal consequences of any policy or pattern of conduct before it is put into operation. What may seem wise from a marketing or financial point of view may have drastic consequences from a legal standpoint. Aside from the personal exposure to criminal liability, particularly under the antitrust and securities laws, the executive has an opportunity to prevent corporate liability as well. Any company has an official policy prohibiting its employees from engaging in anticompetitive practices or securities law violations. This official policy may be communicated by way of a memorandum or an agreement that the employee must sign. The executive is in a position to breathe life into the policy by conveying to his or her subordinates that the policy is vital. Many cases have found corporations and individuals guilty once it became clear that the official policy was merely window dressing and that employees were given subtle messages by their bosses that they had free rein to do what they felt was best. The executive puts the policy into practice by making it clear that the policy is immutable and that those who fail to understand its importance have no future in the organization, he or she may be preventing a future indictment.

Officers and directors are extremely conscious of indemnification opportunities should they ever be held accountable for acts carried out on behalf of the corporation. Permissable indemnification plans vary from state to state and from corporation to corporation, and it is thus difficult to generalize. Most indemnification plans allow reimbursement to an officer or director for the costs of criminal proceedings. However, this indemnification is limited to instances when the defendant had no reason to believe that his or her conduct was illegal. A defendant who has been found guilty of a crime requiring mental culpability will be hard pressed to argue that he or she reasonably believed that the conduct was lawful. Failure to consider the legal significance of one's actions does not meet the test for indemnification; only a good faith belief that the conduct was not unlawful does. Perhaps the defendant in *U.S.* v. *Parks* could have argued a good case for indemnification from Acme, but a person who trades securities on inside information or who conspires with others to perpetrate a group boycott of a competitor would not. When a corporation does indemnify an individual it pays all costs associated with the lawsuit including attorney's fees, judgments and costs of appeals. When indemnification is not available these costs are borne solely by the individual along with the stigma of a criminal record and the almost inevitable dismissal from the firm should the defendant be found guilty.

A foreseeable use of the criminal sanction in the future may be to extract a social responsibility from white-collar defendants. Two events in the last few years seem to signal a consciousness that the criminal justice system with its penalties may be a means of inducing a heightened sense of responsibility to the public on the part of business and its executives. The first was the criminal trial of Ford Motor Company when the state of Indiana charged the company with reckless homicide after occupants of a Ford Pinto burned to death in a fire caused by an erupting gas tank. Ford had been found liable in civil suits brought by other plaintiffs and had been subject to investigation by federal agencies as a result of the Pinto design, but this suit sought criminal penalties, not damages. The jury ultimately acquitted the company when it determined that the prosecutor had not proved the state of mind of recklessness beyond a reasonable doubt.

The significance of the Pinto suit, however, lies not in the results but in the fact that

charges were brought at all. A nagging question left by the verdict is whether the jury that could not find an organizational recklessness would have reached the same conclusion if the individual decisionmakers had been charged rather than the corporation. The message conveyed by the instituting of the lawsuit was that a product design decision that exposes users to a grave risk of harm may be subject to criminal penalties as well as the more traditional civil and administrative sanctions.

The second event that is symbolic of the use of criminal penalties to impose social responsibility on business is a bill introduced in the House of Representatives last session. The bill imposed fines of not less than $50,000 and/or imprisonment of not less than two years on an appropriate manager who discovered a serious danger associated with a product or business practice and failed to notify the appropriate federal agency and affected employees.[5] The bill was drafted in the wake of the Ford criminal proceedings and the controversy surrounding chemical waste disposal. Although the bill died in committee it stands as a reminder that interest in the use of criminal penalties against business practices injurious to the public has been piqued.

The two aforementioned instances present different examples of the future use of criminal proceedings against business activities. In the Ford Motor case the state charged the company with violating an existing traditional criminal statute that covers many types of behavior other than exploding gas tanks. In the second example a statute was proposed that would specifically address conduct within the business environment. Both stand as prototypes of the directions criminal liability of directors and officers may take.

While no policy or program absolutely insures insulation from liability, the foregoing would suggest that officers and directors should not only conduct their own business activities so that they comport with the letter and spirit of the criminal statutes to which they are subject, but should also undertake a program of aggressive oversight of corporate business for which they are directly responsible. In this way potential threats of criminal liability may be defused before they become actual violations. Liability prevention is an important aspect of business planning. The potential loss of liberty, loss of position, and public opprobrium that accompany conviction are drastic consequences to be considered and avoided through a diligent program designed to reduce the risk. Criminal liability for corporate executives is too great a threat to be ignored.

FOOTNOTES

1. Ind. Code § 23-1-10-3(a).
2. Ind. Code § 23-2-1-18.[1]
3. Ind. Code § 23-1-10-3(b).
4. U.S. v. Park, 421 U.S. 658 (1975).
5. H.R. 4973.

Securities Regulation in the 1980s

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As Professor Metzger has pointed out in a preceding article, a useful study of law must include not only an examination of the present state of the law, but also a consideration of the social needs and values that provide the rationale for law. An understanding of the sociohistorical perspective of law enables the business person to anticipate changes in the law.

Such a sociohistorical analysis is especially important to an appreciation of the law of securities regulation. Securities regulation is based primarily upon perceptions of our society's needs in the 1920s and 1930s. The passage of time has proved that many of those perceptions were and remain flawed.

Let us begin with a history of securities law in the United States. Contrary to popular belief, the state governments pioneered in securities regulation twenty-two years before the first federal statute appeared in 1933. Designed primarily as investor protection schemes, the state securities laws (called Blue Sky laws) usually permitted the sale of only high-quality securities, that is, ones whose offerings were "fair, just, and equitable" to investors. Such a standard gave considerable discretion to state securities commissioners, who used the power liberally to deny to many entrepreneurs and businesses the right to sell securities. The underlying rationale of the statutes was that investors, who were generally unsophisticated in securities matters, were easily duped by slick securities salesmen, usually representing East Coast interests.

The Blue Sky laws prevented not only the sale of many risky securities, but also the offering of securities for worthwhile businesses. Although the statutes were overly restrictive, the states justified the results on investor-protection grounds. In addition, at least one state, Kansas, passed its Blue Sky law partly as a response to the large outflow of capital from Kansas to New York. In this respect state securities laws were a reaction to the era when an Agrarian West was bled by a Moneyed East.

When the federal government passed its first securities legislation, the Securities Act of 1933, Congress adopted a scheme dramatically different from the state statutes. Operating under the belief that given sufficient information an investor can decide the wisdom of investing his money in a particular business, Congress opted for a disclosure statute listing the data any offeror of securities must provide to prospective buyers. To encourage carefully considered purchase decisions the Securities Act of 1933 mandated a twenty-day waiting period during which only offers and no sales may be made, thus allowing the investor to

make his decision free from the effects of high-pressure sales tactics.

Federal securities law ostensibly evinced two purposes. The first was the protection of investors, a purpose identical to that of the state Blue Sky laws. But while the state laws considered investors incompetent to make their own investment decisions, Congress believed that a fully informed investor could protect himself. The second purpose of the federal act was to restore investor confidence in the securities markets and, thereby, to preserve the market for capital formation. Largely due to the preeminent position of the consumer during the last fifty years of American law, the second purpose was subordinated to the goal of investor protection and often was forgotten when the Congress and the Securities and Exchange Commission passed new laws and regulations.

The Failures of Securities Regulation

Few regulatory schemes have failed so miserably yet survived so long as federal securities law. Nearly all of the disclosure required by the federal securities acts is irrelevant to investors. Based upon an historical cost accounting system, the disclosures are inaccurate predictors of future performance. Only recently and in very restricted form has the SEC permitted the disclosure of projections of financial performance in offering documents and annual reports.

What mandatory disclosure is made to investors is often old data. Already the market for investment information has disseminated the important data. If anything, the required disclosures operate as a verifier of the accuracy of earlier disclosures.

Most of the mandatory disclosures are not readable or understandable except by the most sophisticated of investors. Many investors do not read the disclosures, either because of the complexity of the disclosures or because the disclosure documents arrive after the investment decision has been made. These two indictments, that the disclosures are not readable or read, expose the myth of the informed layman. In fact there are few fully informed investors. Most people rely upon others to evaluate an investment and believe that since others are purchasing and recommending the security, it must be a good investment.

In light of the slight use of mandated disclosure, the cost is especially high. The expense of an initial offering of securities ranges from $300,000 to $1,000,000, an amount that must be added to the offering. For a small business this cost deters the making of a public offering and, thereby, inhibits small-business capital formation. When one considers that investors, the beneficiaries of mandatory disclosure, are not the neediest members of our society, the expense of mandatory disclosure seems especially high.

In addition, our scheme of regulating transactions in securities has not prevented some of the greatest securities scandals in our history. Thousands of people lost significant investments in the Penn Central and the Equity Funding debacles. Trading on inside information is rampant and largely undetected. It is not difficult to understand why the small investor has little confidence in the integrity of the stock market.

The Future of Securities Regulation

Viewing the failures of securities regulation, are we correct to assume that the law will change in the next several years? I think the answer is yes. Already modifications have been made to reflect changes in our perceptions of society's needs.

First, consider small capital formation. In the 1970s the Congress and the SEC recognized the importance of small businesses to the economic viability of our society. What followed were statutes and regulations increasing the ability of small business to raise capital publicly and to avoid the expensive Securities

Act registration requirements. The small-offering exemption was increased gradually to $2,000,000 from $100,000. A new rule, Rule 242, now allows a corporation to avoid even the low-level disclosure requirements of Regulation A. Last year Congress provided a new exemption for venture capital companies, permitting an offering to accredited purchasers of up to $5,000,000.

The trend favoring small-business capital formation is likely to continue. In the 1980s we should see greater cooperation between Congress, the SEC, and small business. The result will be the enactment of more innovative exemptions from securities regulation and an increase in the offering amounts exempt from regulation.

Closely associated with the grant of preferential treatment to small businesses will be the placement of greater responsibility upon investors and the market to protect investors. This trend is not necessarily a boon for offerors of securities. As investors increasingly rely upon the market to provide and to assess investment information, greater responsibility for truthfulness will be imposed on offerors and securities professionals. It is likely also that we will see an increased judicial acceptance of novel theories of liability.

Just recently, in late May 1981, the United States Court of Appeals for the Fifth Circuit held that a bond purchaser who did not actually rely on a misleading offering circular accompanying the bond offering may nevertheless recover for fraud from the seller under Rule 10b-5 on the grounds that he purchased the bond relying on the integrity of the securities market to establish the apparent genuineness of the securities.[1] The importance of the court's decision is its recognition of reality: investors often do not investigate a security independently, but they rely upon others in the market to research the security. The next logical step beyond this decision is the investor holding liable other market participants for erroneously valuing a security. This step is not likely to be taken in this decade, if ever. Probably, the decision of the Fifth Circuit also will be overruled as unjustified by the reading of Rule 10b-5. In addition few other courts will be willing to permit an investor to abdicate his responsibility to exercise due diligence in his own affairs.

An area in which we are likely to see much talk but little change is insider trading. New SEC Chairman John Shad has emphasized his intent to reduce the level of insider trading, but there are two reasons why insider trading will not abate significantly. First, most investors are hypocritical on insider trading: it is evil when someone else does it, but proper when we do it. This inconsistency is due in part to the abnormal profits that trading on inside information may produce, which interfere with our sense of morality. Second, insider trading is largely undetectable. The novice may be caught, but the experienced trader knows how to interrupt the connection between the insider and the trader, making tracing nearly impossible. No market surveillance program can probe the mind of a trader or otherwise prove that he possessed insider information. Insider trading is a market inequity that we cannot eliminate.

Potential for change exists in the disclosure policy of securities, yet it is unlikely to occur. Despite widespread criticism of securities disclosure Congress and the SEC seem committed to maintaining the present disclosure system as a means of protecting investors. Only one factor will lead to a change in disclosure policy and that is a greater recognition that investor protection concerns must be tempered by concerns for fostering capital formation. We will reach a point at which our nation's need for capital will exceed our interest in investor protection. We are nearer that point today than ever in the history of securities regulation, yet we will not progress far enough in the 1980s to witness a significant change in securities disclosure policy.

A Final Note

The purpose of this article has been to impress upon you that our law is not capricious, but instead is dictated by community and economic conditions of the past and present. Additionally it is nearly impossible to impose a law upon a society that is unwilling or unready to accept it. An implication of this relation between law and society is that we are bystanders in the legal process, that is, lawtakers, not lawmakers.

That observation is partly true. As lawtakers we must accept the law and adapt to it. By increasing our understanding of the relation between law and society, we will improve our ability to accept and to anticipate changes in the law.

But we are lawmakers also. While we cannot in the long run force an unacceptable law upon an unwilling people, we can amend laws that, because of changes in our society or distorted visions of our society, are not compatible with society's best interests.

FOOTNOTE

1. Shores v. Sklar, 647 F.2d 462 (5th Cir. 1981).

The Seller of Goods Under the Bankruptcy Reform Act

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The state-by-state passage of the Uniform Commercial Code ("Code") in the middle of this century created many difficult conflicts with the 1938 Bankruptcy Act. This was especially true with respect to an old and continuing bankruptcy problem: the rights of a party who sells goods to an insolvent buyer, is not paid, and risks losing the goods or their value after the buyer goes into bankruptcy. The passage of the Bankruptcy Reform Act in 1978 has eliminated some, but not all, of these problems. This article will briefly examine the legal position of such a seller under the Bankruptcy Reform Act. It will discuss only the most significant legal options available to him.

Credit Sales

A party who sells goods on credit and is not paid will, of course, be able to sue the buyer for their price. Where the buyer is insolvent and goes into bankruptcy, however, this remedy will often be of little use to the seller because he will be reduced to general creditor status and typically will recover only a few cents on the dollar, if that. Where the credit seller discovers that the buyer has received goods while insolvent, though, he may be able to *reclaim* them under Code section 2-702 if he makes a proper "demand" within ten days after they are received by the buyer. What constitutes an

adequate demand is very unclear. Some courts have treated a mere oral demand, e.g., a telephone call, as sufficient. Others have said that some attempt to regain possession is necessary. In any event, the ten-day demand requirement does not apply where the buyer has made a written misrepresentation of solvency to the seller within three months before delivery of the goods. Still, the seller must actually rely on the written misrepresentation in making the sale, and must also act with reasonable prudence in doing so.

Section 2-702, it might be noted, is merely the Code's reenactment of the common law remedy of rescission[1] for fraud. Prior to the enactment of the Code, it was almost universally true that where the seller could prove the numerous elements of a successful fraud claim he would be able to recover the goods from the bankruptcy trustee. Section 2-702 expressly blocks any recourse to pre-Code law, but under that section the seller has not fared so well in bankruptcy as his pre-Code predecessors did. For some twenty years prior to 1978, the 2-702 seller's ability to recover from the trustee was a matter of immense confusion. Bankruptcy judges and referees employed various provisions of the Bankruptcy Act to defeat the credit seller, and higher federal courts, while generally favoring the seller, did not eliminate these efforts entirely.

In order to resolve this problem, Congress enacted section 546(c) as part of the Bankruptcy Reform Act. Section 546(c) is a mixed blessing for the credit seller. It basically establishes his section 2-702 right to recover in the bankruptcy context. And, overriding 2-702, it also allows the seller to utilize some pre-Code fraud theories as a means of recovery. But, in either case, it toughens section 2-702's tests somewhat. The sale must be in the ordinary course of the seller's business, possibly excluding bulk sales and sales by a nonmerchant from receiving section 546(c)'s protection. More importantly, the section requires that the seller make a *written* demand for the goods within ten days of their receipt by the buyer and says nothing about section 2-702's "written misrepresentation" exception to this requirement. Despite this tougher demand requirement, section 546(c) should eliminate almost all of the reclaiming credit seller's prior problems in cases where its tests are met. But it fails to deal with the seller who meets *section 2-702's* requirements, but fails to satisfy *section 546(c)'s* somewhat different standards. For instance, what happens where there has been a written misrepresentation of solvency by the buyer, and the seller, as allowed by section 2-702, does not make a demand at all? Section 546(c) could be read as an "all or nothing" provision blocking the seller's recovery in such cases. On the other hand, it may merely leave the seller in the position he occupied prior to the Bankruptcy Reform Act, where he confronted a trustee armed with numerous potential bankruptcy weapons for defeating his claim. For all of these reasons, the credit seller's compliance with section 546(c)'s written demand requirement is very important.

Cash Sales

One possible option for a seller wishing to avoid the problems discussed above is to deal with the buyer on a "cash" basis. A cash sale is basically one where the parties agree that title to the goods will pass only upon the buyer's payment of the price. At common law, this included the simple deal where the buyer actually paid cash, sales where the buyer paid by check, over-the-counter sales, and self-service store sales. Because title to the goods did not move until payment was made, the cash seller usually had little trouble recovering against the trustee where the buyer failed to pay and then went into bankruptcy. In effect, the goods never became the buyer's property and thus could not become part of the assets subject to the trustee's control.

The Code generally reenacts the common law "cash sale" doctrine. Under the Code,

however, section 2-702's ten-day demand requirement almost always applies to cash sale reclamations. This can prove very disadvantageous to the seller in "bad check" cases because the ten-day period may well elapse before he will become aware that the check has bounced. As was the case with the Code credit seller, the Code cash seller attempting to recover goods sold to a bankrupt buyer had mixed chances of success. Many of the protrustee arguments employed in 2-702 cases also were employed to defeat the cash seller under the 1938 Bankruptcy Act.

The position of the reclaiming cash seller under the Bankruptcy Reform Act is uncertain. In yet another sin of omission, section 546(c)'s drafters did not make clear whether that provision extends to the cash seller. If the cash seller is *not* included within 546(c)'s coverage, all the prior Bankruptcy Act problems are likely to reappear in much the same form. If, as is more likely, section 546(c) *does* cover the Code cash seller, many of the difficulties raised above with respect to section 2-702 will confront the cash seller. In any event, it is extremely important that the unpaid cash seller make a demand as soon as he discovers the buyer's insolvency—in writing if at all possible. Because of the problems this will often pose in bad check cases, and because of the cash seller's uncertain position under the Bankruptcy Reform Act, the "cash sale" strategy may not prove especially useful to the seller attempting to protect himself when dealing with buyers of doubtful solvency.

Withholding Delivery and Stoppage in Transit

In certain relatively infrequent situations, the seller dealing with an insolvent buyer may be able to protect himself against loss of the goods in bankruptcy by withholding delivery or stopping the goods while in transit. The Code allows the credit seller to refuse delivery except for cash when he discovers the buyer's insolvency. If the buyer fails to pay cash, the seller can continue to withhold delivery. Also, the Code permits the seller to withhold delivery where the buyer fails to make a payment due. In our situation, this should benefit only the seller who delivers in several installments. Where the goods have already been shipped but have not yet reached the buyer, the seller can stop them in transit once he discovers the buyer's insolvency.[3] However, reasonably prompt notice must be given to the carrier, and the right to stop goods in transit terminates fairly quickly.

Under both the common law and the Code, the seller who successfully withheld delivery or stopped the goods in transit defeated a trustee asserting a claim to such goods after the insolvent buyer went into bankruptcy. There is little reason to think that there would be a different result under the Bankruptcy Reform Act. However, as a practical matter the seller's use of such strategies will be infrequent. They usually depend upon a quick and well-timed discovery of the buyer's insolvency. In the case of stoppage in transit, fairly prompt notice to the carrier is required, and the period during which stoppage can occur is fairly limited. Moreover, both options tend to be of practical use to the seller only where he is delivering on an installment basis.

Perfection of a Security Interest

In view of the problems presented above, the safest course for the seller dealing with buyers of uncertain solvency is to obtain a perfected security interest in the goods sold. This would be what the Code calls a "purchase money security interest." The purchase money security interest is the current version of the pre-Code conditional sale, in which the seller typically transferred possession to the buyer but retained title as security for the price until he completed payment. The two necessary (but not sufficient) conditions for the seller possessing such an interest to defeat the trustee are called *attachment* and *perfection*. Attachment in-

volves those steps that must be taken for the security interest to be valid *against the debtor.* Perfection involves those steps necessary for the security interest to be valid *against third parties* such as the bankruptcy trustee.

In order for a purchase money security interest to attach, there must be a written security agreement granting the creditor (the seller) a security interest in the collateral (the goods sold), signed by the debtor (the buyer). Perfection of a security interest typically involves filing a *financing statement* in the appropriate place of record. However, the Code allows a purchase money security interest in *consumer goods* to be perfected without filing–effectively, upon attachment.[4] Consumer goods are goods used or bought for personal, family or household purposes. It is important to note that the status of the goods as consumer goods is determined by the use to which they are put by the buyer. If the seller sells a refrigerator to be used in a home, the refrigerator will qualify as a consumer good, but if it is sold to a wholesaler for resale or for use in an office, this will not be true.

From the above, it would seem that the creditor/seller who perfects his interest before bankruptcy would always be safe from trustee attack. There are at least two situations, however, in which a purchase money security interest perfected within the ninety days preceding bankruptcy may be declared a "preference" and invalidated by the trustee.[5] The principal purpose behind the act's preference provision is to prevent transfers of the debtor's assets to favored creditors before bankruptcy. First, the Reform Act, like the Code, gives the purchase-money-secured party a ten-day grace period within which to perfect. If such a party fails to perfect his interest within ten days from attachment, his security interest is likely to be treated as preferential and he will not recover the goods from the trustee. Second, a credit seller who deems himself insecure and takes out a perfected security interest to cover a *preexisting* debt should also be vulnerable to the trustee if this occurs within ninety days of bankruptcy. This would be true even if the seller perfects within ten days of attachment, so long as the actual debt occurred before attachment.

Thus, the seller desirous of maximizing his protection when dealing with buyers of doubtful solvency should get the buyer to sign a proper security agreement at the time of the sale, and file a financing statement immediately–or, at the latest, within ten days. However, if the sale involves goods to be used for consumer purposes by the buyer, filing should not be necessary. In nonconsumer goods cases, the failure to file within ten days will severely imperil the seller's chances of recovery from the trustee. Finally, security interests taken out *after* the sale are not likely to assist sellers if they occur within the ninety-day preference period. Compliance with such procedures may be inconvenient, but they afford the seller the most complete protection against loss of the goods in bankruptcy.

FOOTNOTES

1. Rescission might be defined as a remedy whereby the court takes the completed deal apart and restores the parties to their original precontractual position. Here, where the buyer has not paid, this would simply mean that the seller could reclaim the goods.

2. The seller may have other Code remedies in this case also. See U.C.C. 2-703.

3. In addition, where large shipments (truckload, carload, planeload, etc.) are involved, the seller can stop delivery in a larger range of situations. For smaller shipments, though, only discovery of the buyer's insolvency will trigger the right of stoppage. The reason for this distinction is to protect carriers against the burdens which would result if the seller had the right to stop small shipments for reasons other than the buyer's insolvency.

4. One purpose of this provision is to prevent the rash of filings a contrary rule would create. But section 9-302(1)(d) specifically states that filing *is* necessary for a motor vehicle required to be registered.

5. The ninety-day period may be extended to one year where the security interest is given to certain "insiders."